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Transcript

The Descent of Finance: Geopolitical Implications of the Crisis

The Dillon Lecture

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Niall Ferguson:

Good morning, ladies and gentlemen. It's a great pleasure to be here back at Chatham House on a characteristically rainy and miserable London morning – afternoon, I should say.

I want to say a few more words about Douglas Dillon before I begin my lecture. Clarence Douglas Dillon was in fact the son of one Anne Douglass, who was descended from the Grahams of Tamrawer Castle at Kilsyth. So I actually have an affinity with him, in that Scottish respect. But what's less well known is that Dillon's father was born 'Lapowski'. He was in fact the son of a Polish Jewish immigrant. The name 'Dillon' was a made-up name, but it came to grace what was once one of the most dynamic firms on Wall Street, Dillon Read. He was also a Harvard man. A banker then before he became a diplomat, but interestingly one of his major contributions to New York's cultural life was to build up the Chinese art collection of the Metropolitan Museum. For all these reasons – the Scottish connection, the Polish Jewish connection, the financial connection, the political connection and perhaps above all the Chinese connection – I think Douglas Dillon would have found this an interesting lecture, though not necessarily a particularly cheerful one.

My theme today is the descent of finance, or perhaps I should simply have called it 'The End of Chimerica'. What I want to do is to develop some of the themes in my most recent book *The Ascent of Money*, copies of which you'll see piled high there. And in particular I want to explore the question of that relationship between China and America, which a couple of years ago I tried to sum up in an article co-authored with Moritz Schularick as 'Chimerica', an economic fusion between the two most important economies at the core of the process of globalisation. When we first wrote about Chimerica in the *Wall Street Journal*, Moritz and I always had a pun in mind. The idea was that Chimerica was inherently a chimera. A chimera, as you know, is a mythical, non-existent beast, I think part-goat, part-lion, part-dragon. And our assumption was that the extraordinary symbiotic relationship between China and the United States, which evolved in the decade or so leading up to this spectacular financial crisis, was inherently an unstable one. For those of you who haven't read the book, I can simplify the idea by comparing it to one of those unhappy marriages in which one partner does all the saving and the other partner does all the spending. One partner is thrifty; the other is profligate.

In economic terms, China was basing its growth strategy on exports to the western world and particularly to the increasingly leveraged – that is to say indebted – American consumer. And this had a number of unintended consequences, one of which was that Chinese intervention to prevent the Chinese currency, the 'renminbi', from appreciating relative to the dollar led to a huge accumulation of US dollar-denominated securities in the portfolio of the Beijing monetary authorities. Round about 70 per cent (we don't know the exact figure) of China's 2+ trillion dollars of international reserves are in the form of dollars. What this meant was that unwittingly, and certainly not altruistically, China was financing a very large part of the US current account deficit and indeed the US government's fiscal deficit.

Let me illustrate the point. Right now the People's Republic of China holds approximately 13 per cent of all the federal debt held in public hands that is not held by agencies of the federal government itself. At its peak on the eve of the financial crisis in 2007, China was buying three-quarters of all new bonds issued by the US Treasury. Three-quarters. In effect, to use terminology from an earlier book of mine, the American empire had become reliant on a credit line from the People's Republic of China. The point that Moritz and I wanted to make in our Chimerica articles, and we wrote several, was that this was not sustainable. One consequence of this huge accumulation of dollar-denominated securities was that US long-term interest rates were artificially depressed. They were held down lower by between 100 and 200 basis points that would otherwise have been the case, if the Chinese had not pursued this policy, if, say, the Chinese had allowed their currency to appreciate which under earlier currency regimes would probably have been the natural sequence of events. Think back to Bretton Woods when West German currency, the Deutschemark, the Japanese yen were periodically revived, relative to the core currency, the dollar.

As we suspected, the consequence of Chimerica was to propel asset markets, and particularly the real estate market in the United States, into a bubble. Now, I don't want you to think that we blame everything on Chimerica – on the contrary. *The Ascent of Money* makes a six-part argument about the causes of the crisis and, unlike books by economists, it is based on historical data rather than some abstract and incredible mathematical model.

So Chimerica's part of a bigger story, but I want to focus on Chimerica today because it's appropriate at Chatham House to explore the relationship between economics and geopolitics. That's really what I want to focus on, but first I need to say a few words about where I think we now are as the Chimerican bubble (for want of a better phrase) continues its painful deflation.

I've just come back from Istanbul where I was attending the International Monetary Fund/ World Bank conference or conferences and it's clear that the conventional view is now established that we have avoided Great Depression 2.0. Most people I think recognise that the worst is behind us and the conventional view is that we've done that through a combination of massive monetary and fiscal stimulus – what I would call the 'Friedman-Keynes double whammy'. We've simultaneously used monetary methods and Keynesian methods to try to counter what seemed like a potential great depression. What many people in the United States and elsewhere, including it should be said in China, now worry about is that there could as a consequence of the huge deficits being run by the United States – just to give you a number, the federal deficit this year is likely to be between 11 and 12 per cent of gross domestic product, a figure vastly in excess of anything we've seen since World War II – and to give you another number, the Federal Reserve effectively doubled its balance sheet in the wake of last year's bank panic – it seems to many people that this must ultimately produce inflation. This is the argument that I think we need to say a few words about before we get on to geopolitics. You'll see that it has a bearing on the question of power as well as economics.

Are we headed for inflation? Is it inevitable that if the United States runs such a large deficit and cumulatively it's forecast to run a nine trillion dollar deficit over the decade, will we end up with the Fed printing money and a descent into the kind of inflation we last saw in the western world in the 1970s? I'm asked about this a lot. Maybe it's because the first book I wrote was about the German hyperinflation or perhaps, because I wrote that book, I can authoritatively answer in the negative. There is very little sign at all in the world today of an inflationary threat. On the contrary, the real threat that we face is still deflation and let me say why I think that is. First of all, you may have noticed that the core inflation, which is what the Fed tends to focus on, is still just in positive territory. Headline inflation is actually negative at about -2.1 per cent year on year. That's mainly being driven by a dramatic decline in the price of energy, which is at the order of a 23 per cent decline in the space of 12 months. If you look at the classic driver of inflation in the western world – wage pressure – it's almost non-existent right now and that, of course, reflects the fact that there's enormous overcapacity and rapidly rising unemployment in most of the major developed world economies. Turning to

China, the striking thing is that inflation is clearly negative there despite a massive expansion of credit that the Chinese initiated as part of their stimulus package. If you just look at the index for Chinese export prices, it's falling at an annual rate of about 15 per cent right now.

I'm going to give you about seven reasons why I think we're not out of the woods, why inflation is not something we should be concerned about and why if anything the major threat is deflation. I'm going to do it relatively swiftly in order to clear the decks for my geopolitical implications. These are intimately connected as I hope you'll see.

The critical point – point number one – is that the United States consumer is not coming back any time soon in the spend-thrift credit card waving way that we grew accustomed to over the past decade or so. If you look at real median household income, average household income adjusted for inflation, it is the same today as it was in 1998. So the average American household's income has flat-lined in real terms. Between a quarter and a third of all mortgage holders in the United States are now in negative equity or 'under water' as we sometimes say. The percentage already in foreclosure or close to foreclosure is certainly now above 12 per cent and rising. Household debt in relation to disposable income, by contrast, is at a higher level despite some de-leveraging than it was back in 1998. Right now household debt is roughly 118 per cent of disposable income, down from the peak which was 127 per cent but much higher than that 89 per cent in the late 1990s. So if you think of US households' balance sheets, it's not a pretty picture because the incomes have basically stagnated, the assets that they borrowed to invest in have collapsed in price, whether in housing or in the stock market. But they're left with the enormous debt burden that they accumulated in the good times.

There's no way back to the age of leverage, at least in the private sector. Right now consumer credit is contracting at really quite a rapid rate. And the Bank Credit Analyst recently forecast that there could not be growth of consumer expenditure much above an annual rate of 1.3 per cent over the next 10 years. You'll understand, no matter how limited your interest in economics, that if the US consumer is increasing spending at no higher a rate than 1.3 per cent, the chances of a rapid rebound of the US economy are very rumoured indeed since the US consumer accounts for something like 70 per cent of gross domestic product.

The administration of President Obama forecast in its budget earlier this year that growth next year in the US economy would be in real terms 3.2 per cent, the year after that 4 per cent, and the year after that 4.6 per cent. In my opinion, those figures are highly unlikely to be achieved and I would think that a best-case growth rate would be half those numbers. So that's point number one. We're not likely to see a return to those happy days of refinancing your mortgage and hitting the shopping mall.

The second point, which is really striking, is that world trade suffered a collapse in the past year – unprecedented actually in modern times. It was a steeper collapse than happened in the Great Depression. Just to take one measure, the Baltic Dry Index measure of the volume of trade fell by 80 per cent from peak to trough and has scarcely recovered from that level. If you travel as much as I do, you can't help but notice the container ships sitting idly, whether it's in Hong Kong or in Istanbul, and they're very high out of the water because they're empty. And there's nothing doing.

Commodity prices are still down by between a third and a half from their peaks last year - another reason why deflation is a much more likely scenario that inflation. And that, of course, reflects what the IMF likes to call the 'output gaps', the gaps between actual and potential production in the major economies of the developed world. The latest IMF figures give Japan a huge 8 per cent of GDP output gap. That hasn't occurred at any point since records of the output gap began. And the figures are not a lot better for the major European economies: 5.8 per cent for Germany, for this country 5.5 per cent, France 4.5 per cent. For the US, more than 4 per cent.

My fifth reason to anticipate a deflationary period in the western world at least is that banks, which were after all the epicentre of this financial crisis, continue to be squeezed and to squeeze the economy. In some recent articles I joked about the advent of a new entity: the TBTF. TBTF stands for 'too big to fail' and a very tiny number, maybe a dozen institutions in the world now, account for a very huge proportion of financial transactions and assets, but because of what happened last year they now are implicitly guaranteed by governments. Because nobody would dare risk another Lehman crash. Now I hesitate to mention it with John sitting there as Chair, given his past association with the late, but not terribly lamented, Lehman Brothers investment bank.

The TBTFs, despite the government guarantees that have been given to them – these are the 'survivors' of the crisis: Goldman Sachs, Morgan Stanley, JP Morgan, Citigroup and so forth – are nevertheless under pressure from their new quasi-guarantors to, in the parlance of our time, de-leverage. That is, to reduce the ratio between their assets – the loans they make – and their core equity capital. Considering that the governments who are telling them to do this want to achieve recovery, it's a little bit contradictory. The idea is that the banks will re-capitalise themselves, but as Tim Congdon has been arguing for some time, and here I think he's bang on, the effects of the pressure in fact is to cause the banks to contract their balance sheets more than it is to cause them to re-capitalise, though there are exceptions to that rule. So there's a process of de-leveraging even amongst the guaranteed banks that have survived the crisis as TBTFs.

Then there are the TSTSs. They're the 'Too Small To Survives', the banks that weren't big enough to acquire an implicit guarantee in the crisis of last year. They're failing at a very rapid rate in the United States at the moment. There are about 2,250 banks that rated 'F' when the Institutional Risk Analytics went through the US banking system. That's a very large proportion of all banks since there are fewer than 8,000 in the US today. And of that number, roughly a thousand are likely to fail within the next six to twelve months.

So there's going to be a contraction in the financial system in the United States, despite all that's been done so far because of a crisis among smaller regional and local banks. That is why credit is contracting in the United States despite massive monetary expansion by the Fed. That expansion of the Fed's balance sheet is not translating into significant expansion of broad monetary measures and if you measure credit we're actually in a time of contraction. It's inconceivable that we could have inflation under those circumstances.

Meanwhile, point number six, the fiscal crisis called into being (not by this crisis because it's been in existence for some considerable time in the United States) has reached a new peak of seriousness because of emergency measures conducted, adopted rather, in the last two years.

As I mentioned already, the official projection for the ten-year cumulative deficit is nine trillion dollars. Already the federal debt is increased by about a third since this crisis began and gross debt is likely to hit 100 per cent of GDP within the next five to seven years. We're heading for a situation, and it could be as soon as next year, when total debt is roughly six times total tax revenue. And in the excellent recent book, Kenneth Rogoff, my colleague at Harvard, and Carmen Reinhart show that when debt to revenue gets to that point in the wake of a major financial crisis there are generally only two ways out: default or inflation.

I want to suggest that there's a third possibility and that third possibility is stagnation, when the debt burden just won't go away, your growth doesn't pick up but your creditors won't let you inflate because the term structure of your debt is relatively short and the investors are no fools. In other words, you have to imagine that over the next seven years or so there's going to be a sharp increase in payments of interest on a rapidly growing federal debt. Even if we live in a low interest rate world, interest payments are going to eat a big share of total tax revenues. I estimate it's rising from around 7 per cent of total federal receipts to 16 per cent by 2016. It will go much higher if, as I fear, normal interest rates rise. If the huge supply of new bonds on the international market is not met by an equal demand. I can talk more about that point in the discussion if it interests you.

There is, of course, evidence of recovery in the United States. I'm not gainsaying that. Monetary stimulus and fiscal stimulus have achieved something of a rebound, not only in terms of output but perhaps more noticeably in terms of asset prices. The problem is as soon as the United States starts to recover our old friend the trade deficit, or current account deficit, starts to widen again. It narrowed by about 50 per cent in the crunch. Now it's growing at a rapid rate. In the most recent monthly figures, imports were up 4.7 per cent, exports were up only 2.2 per cent. Now you don't need to have a Nobel Prize in economics to see that there's a problem if consumption is essentially going to be growing at a very low rate and, if net exports are negative, we're not left with a whole lot to propel the US economy forward.

The critical point, and now I come to the core of my argument, is that whereas up until recently the United States could rely on the People's Republic of China to finance a substantial part of its borrowing, whether measured in terms of the current account deficit of the federal fiscal deficit, those days are over.

The latest statistics are really quite striking. China's achieved the kind of Keynesian recovery that western economies can only dream about. It seems to me on the basis of the new evidence coming out of China that there must be a significant multiplier in Keynes' sense. They've done this big state-driven infrastructure investment programme but it is now clearly spilling over into rising incomes, rising consumption and we are seeing a distinct decline in the household savings rate, as the Chinese get it if they're to rebalance, as they keep being told to rebalance the global economy, *they* have to be consumers now. They cannot simply be savers and expect the rest of the world to consume their stuff.

In the first half of this year China absorbed less than 10 per cent of new US Treasury issuance, compared, remember, with a peak of 75 per cent before the crisis began. There is good reason to believe, and here I'm quoting from research by Eric Fishwick at CLSA, that China's trade surplus with the rest of the world will actually vanish next year. There will no longer be a programme of reserve accumulation by China. China will no longer be depending primarily on running a substantial export surplus. And that, of course, has major implications for the United States. If the Chinese aren't there with a pile of savings to recycle into the US deficit, who is going to absorb nine trillion dollars of new issuance over the next decade? China's likely in fact to be a net seller of US dollar-denominated bonds if these trends turn out to be continued.

The Chinese have an alternative and it's fascinating that so few people have realised what the alternative is. Blithely in Washington, I've heard this said frequently in the last 10 months, the Chinese have nowhere else to go. 'Of course they have to hold dollars. What are they going to do? Hold euros? Hold the currency of an area that's doing even worse economically than that United States?' The answer is actually that the Chinese do have somewhere else to go. They have (a) their own consumers to bring online. They can encourage their own households to be the principle buyers of Chinese manufactures and at the same time they can diversify out of dollar-denominated reserves into commodities. And that is exactly what China has been doing. In the last three months, CIC, one of the Chinese sovereign wealth funds, has closed deals worth 4.25 billion dollars with various resource companies around the world. The aim is to acquire copper – you name it actually – any metals and indeed some foodstuffs that are seen as key commodities for China's import-hungry economy.

This is the principle reason though not the only reason why I think witnessing the end of Chimerica. The marriage is on the rocks even if we're not quite in the divorce courts yet. But there are other reasons too. You may have noticed that China and the United States are engaged in something of a trade war following President Obama's decision to bow to trade union pressure and slap a 35 per cent tariff on cheap Chinese tyres. The Chinese have retaliated by investigating alleged dumping by the United States of chicken's feet, would you believe it. Will future historians write about the war of the chicken's feet, I wonder.

There's an awareness in Beijing that Chimerica is coming to an end. There's a debate going on within the communist party leadership, which is one of the most lively there have been in recent years, and the debate is essentially what do we do if this thing is coming to an end. It's the most important question that I think anybody interested in geopolitics can address today.

As China exits Chimerica, moves away from a reserve accumulation policy, ceases to finance American borrowing, we will see I feel sure some upward pressure on long-term nominal interest rates. But if I'm right in all that I've told you, this will be an extremely painful development for the United States because inflation is going to be lower than people expect. That means that the real interest rate on the vast US federal debt is going to be significant and that is why I think what Adam Smith called the stationary state, a period of very low growth, is on the cards for the United States. It's very hard to see how under these circumstances with a rapidly growing debt and upward pressure on the interest rate paid on that debt the United States can escape without significant pain. It's pretty bad news, if you're a highly leveraged empire, to be paying significant real interest rates on your debt.

There's nothing like a weekend in Istanbul to remind you of the fate of the Ottoman empire. You can still see the building where European bondholders established control over the customs collected by the Ottoman authorities to insure that the interest on their bonds was paid punctually.

So this brings me to the geopolitical, long run trend. It seems to me that this crisis has accelerated what was already a perceptible shift from West to East in global economic and geopolitical history. You can call it a divergence but I think it would be more accurate to call it a great re-convergence. We are seeing something like 500 years of history going into reverse. From around 1500 (the economic historians differ about the exact timing), the biggest fact of modern history was the stagnation of Asia and the accelerating growth of the West. It's over. We're at one of history's great turning points and I believe this crisis has accelerated the turn.

I saw Jim O'Neill of Goldman Sachs, who coined the phrase 'BRICs', not so very long ago in Istanbul the other day and he confirmed that it's still the assumption at Goldman that China's gross domestic product will equal that of the United States by 2027. Remember, there was never a time in the Cold War when the Soviet Union came remotely close to catching up with the United States. This superpower really is super. So, *in sorpassa*, which is a phrase we used to use when the Italians fancied they would overtake the United Kingdom, is happening on a vast scale in the world economy today. If Jim and his colleagues at Goldman are right, by 2050 China's GDP could be nearly double that of the United States.

What are the geopolitical implications of this great re-convergence? The first that comes to mind is that the United States will clearly face downward pressure on its discretionary military expenditure, as interest payments consume a rising share of the federal budget. That's always the first thing to get squeezed in a crisis like this. The second thing to bear in mind is that the populist backlash against the great bailout is at a relatively early stage. By the time we get to mid-term elections, not to mention presidential elections, I anticipate that that populist backlash against much of what has been done since the crisis broke will be a major part, a major force, in American political life.

Contrast the situation of China. If China's growth is going to be consistently at the 10 per cent rate and the latest forecasts are in fact that China will grow by 12 per cent next year (a much higher percentage than anybody would have dared to predict six months ago), if that's sustained as I think it probably can be, at least over a decade, then China has much, much more in the way of resources to play with in expanding its already rapidly growing armaments programme. It also has much more to play with when it comes to acquiring quasi-imperial commodity-producing assets in places like sub-Saharan Africa, Latin America, not to mention Australia. Australia is about the only western country that is awake to the implications of what is happening now. That is why the Australians have initiated a large-scale review of their own naval defence strategy. They realise they can no longer assume the United States is the maritime hegemon in the Asia-Pacific region.

The other important point is that China as it grapples with the challenge to the political model called in to being by Chairman Mao sixty years ago, is likely in my view to resort more and more to nationalism to build the legitimacy of the one-party state. It's hard to maintain unrepresentative government if your economy is growing this fast and if a middle class is emerging that expects more than simply propaganda to keep it happy. The Chinese authorities know they've got to offer more than simply rising living standards. My suspicion is that nationalism is the answer.

And this brings me to my concluding reflection. Earlier this year in a debate with James Fallows of the *Atlantic Monthly*, I threw out the idea that this might be history replaying itself with the United States in the position of the United Kingdom a hundred years ago, the weary titan, and China playing the part of Wilhelm I Germany. Not everybody was immediately convinced by this, but let me make a simple point about the nature of China's *weltpolitik* – and I think it's not too much to speak of a Chinese *weltpolitik.* Like Wilhelm I Germany, China is embarking on a major naval armaments programme. It is planning to build up to six aircraft carriers in the years to come. It is already developing or acquiring anti-ship ballistic missiles with a range of 1500 kilometres, Russian anti-ship cruise missiles – it's very obvious what such things could be used against. There are four classes of Chinese-designed and -built submarines, including the new *Jin* class armed with JL-2 nuclear-armed submarine-launched ballistic missiles. And China has already acquired in the past decade or so Russian-made Kilo class non-nuclear powered attack submarines armed with the wonderfully named SS-N-27 Sizzler missiles. Between 1995 and 2007, ladies and gentlemen, China brought into service a total of 38 new submarines of all kinds. It has acquired four *Sovremenny* class destroyers from Russia, nine new home-built destroyers, 20 new frigates and 40 of the so-called Stealth Attack catamarans that are extremely difficult to detect with conventional naval radar.

I say all this not to draw a crude historical parallel but merely to offer some evidence in support of my contention that China is the new Germany, in the sense that China now plays a role in the world comparable in all kinds of ways with the role played by Germany roughly a century ago. It has that rapidly growing economy, it has that capacity to roll out – and you've only to look at the number of engineering PhDs they produce – technologically skilled elites. It is embarking on a significant quasi-imperial expansion in regions like sub-Saharan Africa and it is building a navy which will not be anything like the same size as the US Navy but will soon acquire the capacity to hurt the US

Navy in significant ways, particularly if, for example, there were a dispute over the status of Taiwan.

That seems to me to be the most interesting geopolitical consequence of this crisis. The crisis has accelerated the historical process. It has speeded up that shifting of tectonic plates of power and wealth, which I began to describe in the *War of the World* that was published three years ago now with the subtitle *the Descent of the West*. Of course, this is just a statement with a probability attached. I don't have the power to foretell the future. There is in any case no such thing as 'the future'. There are only 'futures', plural, and it may well be within the power of the United States to reverse some of the negative trends that I've just described, just as it may prove to be beyond the power of the Chinese Communist Party to manage the transition to superpower status. But at the moment, looking at the evidence that I've presented to you, it seems to me the balance of probability is firmly on the end of Chimerica and the beginning of a new age of imperial rivalry.

Thank you very much.